

CARL J. KUNASEK  
CHAIRMAN

JIM IRVIN  
COMMISSIONER

WILLIAM A. MUNDELL  
COMMISSIONER



## ARIZONA CORPORATION COMMISSION

BRIAN C. McNEIL  
EXECUTIVE SECRETARY

MARK SENDROW  
DIRECTOR

SECURITIES DIVISION  
1300 West Washington, Third Floor  
Phoenix, AZ 85007-2996  
TELEPHONE: (602) 542-4242  
FAX: (602) 594-7470  
E-MAIL: accsec@ccsd.cc.state.az.us

# MEMORANDUM

**TO:** All Interested Parties

**FROM:** Securities Division of the Arizona Corporation Commission

**RE:** Summary of Investment Adviser Regulation

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**This document is a summary only. It is provided solely for your convenience. It should not be used as a substitute for an independent, careful review and analysis of the relevant provisions of the Arizona Investment Management Act, Arizona Revised Statutes § 44-3101 *et seq.***

As a result of the National Securities Markets Improvement Act ("NSMIA") and Senate Bill 1097, the scope of the Arizona Corporation Commission's (the "Commission") authority with respect to the regulation of investment advisers has changed. This memorandum attempts to explain those changes by providing a section by section explanation of the law followed by some explanatory questions and answers.

In the attempt to better allocate the regulation and supervision of investment advisory services between federal and state regulators, NSMIA (in particular, the Investment Advisers Supervision Coordination Act thereunder) preempted Arizona and other states from the licensing/registration of certain investment advisers (primarily larger investment advisers), leaving such regulation to the SEC. Generally, the regulation of smaller investment advisers and the regulation of certain investment adviser representatives ("IARs") was left to the states. Thus, the Commission will continue to regulate the provision of investment advisory services in Arizona where such regulation has not been preempted. In this last Arizona legislative session, SB 1097 was adopted. As you know, SB 1097 made many important changes to Arizona securities laws. One of those changes was to incorporate into Arizona law many of the changes created by NSMIA. As mentioned above, NSMIA created distinctions between those investment advisers registered with the SEC ("SEC IAs"), and those investment advisers whom states (including Arizona) will license/register. In addition, NSMIA and SB 1097 changed the reporting requirements for investment advisers distinguishing on the basis of whether the investment adviser maintains their principal place of business in Arizona. Finally, NSMIA placed limits on those persons whom the states may license/register as investment adviser representatives. NSMIA created a

bifurcated system of regulation requiring the application of the new federal definition of investment adviser representative to SEC IAs and the state (Arizona) definition of investment adviser representative to Arizona licensed investment advisers. All of these changes are discussed in detail in this memorandum. In the attempt to make this memorandum a complete reference guide, we have also addressed those areas of investment adviser regulation where Arizona law was not changed by the new legislation.

Please note, that unlike the SEC and most other states, Arizona does not “register” investment advisers or IARs; Arizona **licenses** investment advisers and IARs.

I. Definition of an *investment adviser* **A.R.S. § 44-3101(2)**

- A. Arizona defines *investment adviser* as any person who, for compensation, engages in the business of advising others, either directly or indirectly through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities or who, for compensation and as part of a regular business, issues or promulgates analysis or reports concerning securities. Investment Adviser includes financial planners (fee only or otherwise) and any other persons who, as an integral component of other financially related services, provide the foregoing investment advisory services to others for compensation and as part of a business or *who hold themselves out* as providing the foregoing investment advisory services to others for compensation. (For a discussion of “compensation” please see **Question 26**)

Arizona has several exclusions from the definition of IA, some of which are listed below:

1. Investment adviser representatives
2. Depository institutions
3. Attorneys and CPAs whose performance of investment advisory services are *solely incidental* to the practice of their profession
4. Publishers, employees or columnists of any publication that does not render advice on the basis of the specific investment situation of each client

For a complete list of those excluded from the definition (as well as an elaboration of the exclusions noted above, please refer to **A.R.S. § 44-3101**).

**THE ARIZONA INVESTMENT MANAGEMENT ACT DOES NOT APPLY TO SECURITIES DEALERS OR SALESMEN REGISTERED WITH THE COMMISSION. (A.R.S. § 44-3152(C)).** (For details on the application of this

exclusion, please refer to the discussion in Section V(B) below on Exemptions and Exclusions from Licensure and Notice Filing Requirements)

B. Question and Answer

**Question 1.** Q. Does every person who meets the definition of investment adviser under **A.R.S. § 44- 3101** have to license as an investment adviser in Arizona?

A. No. That is the impact of the new law. NSMIA has removed from Arizona's jurisdiction the power to license all investment advisers. It has divided the registration/licensure power between the SEC and the states based on the value of assets under management of the investment adviser. As a result of NSMIA, Arizona has implemented new laws which address these changes. The most significant of these changes is the "notice filing" requirement which applies to SEC IAs.

II. Licensure and Notice Filing Requirement for Investment Advisers **A.R.S. § 44-3151**

A. **A.R.S. § 44-3151** requires that prior to acting as an investment adviser or IAR in Arizona, the person (i) be licensed, (ii) make a notice filing with the Commission, (iii) be exempt from the licensure requirements, or (iv) not be subject to the notice filing requirements. (For a discussion of IARs, please refer to the Section VI below and **Questions 11-14**).

1. Notice filings, rather than licensure, will be required of all SEC IAs who provide investment advisory services to Arizona clients. As a general rule, investment advisers with more than \$25 million in assets under management are required to be registered with the SEC.
2. Absent an applicable exemption, licensure will be required for all investment advisers with less than \$25 million in assets under management who provide investment advisory services to Arizona clients. (For a discussion of Arizona's de minimis exemption, please see Section V(A) below and **Questions 15 and 16** below).

B. Filing Requirements **A.R.S. § 44-3153** (For further details, please refer to the Investment Adviser Instruction Packet).

1. Licensing Requirements -- An application for licensure shall include Form ADV, proof of compliance with the examination requirements, financial reports if there is custody or a prepaid fee of at least \$500.00 six or more months in advance from any single client, and a filing fee of \$250.00 as set forth in **A.R.S. § 44-3181**.

2. Notice Filing Requirements -- A notice filing shall include copies of documents filed with the SEC which the Commission requires, a consent to service of process and the notice filing fee of \$250.00 as set forth in **A.R.S. § 44-3181**. Currently the Commission will be requiring: (1) a manually executed page 1 of Form ADV or (2) a copy of page 1 to Form ADV and a manually signed consent to service of process Form U-2.

C. Questions and Answers

**Question 2**    Q.    After July 8, 1997, I will be a federally registered investment adviser. What is necessary to withdraw my license in Arizona?

- A.    For an investment adviser to withdraw its license from Arizona, the Commission will require Form ADV-W for the investment adviser and a Form U-5 for each IAR. SEC IAs may wait until the end of 1997 and simply not renew their license. This will save the SEC IA from paying a notice filing fee prior to the end of 1997. If the investment adviser intends to provide investment advisory services to Arizona clients, they will need to either maintain a license or make a notice filing annually. The failure to maintain a license or a notice filing will result in a violation of **A.R.S. §44-3151**. (For Renewal Requirements, please see **Question 5**)

**Question 3**    Q.    What is required to make an initial notice filing in Arizona?

- A.    To make a notice filing in Arizona, an investment adviser must file with the Commission: (1) a manually executed page 1 of Form ADV or (2) a copy of page 1 to Form ADV and a manually signed consent to service of process Form U-2. There is a filing fee of \$250.00 which must accompany any notice filing.

For those SEC IAs shifting from Arizona licensure to a notice filing, the documents listed above must be filed before December 31, 1997. As of that date, the investment adviser license will be terminated.

**Question 4**    Q.    What is required to license as an investment adviser in Arizona?

- A.    An application for investment adviser license shall include Form ADV, proof of compliance with the examination requirements, financial reports if there is custody or a prepaid fee of at least \$500.00 six or more months in advance for

a single client, and a filing fee of \$250.00 as set forth in **A.R.S. § 44-3181**. (Please refer to Investment Adviser Instruction Packet)

**Question 5**    Q.    What is required to **renew** my Arizona license or notice filing?

A.    To renew a license or a notice filing, Arizona requires the payment of a fee of \$250.00. If you are switching from a licensee to a notice filer at the end of 1997, this will be an **initial** notice filing not a renewal.

**Question 6**    Q.    I am a sole proprietor investment adviser, formerly registered with the SEC, and a registered securities salesman in Arizona. May I license in Arizona?

A.    Yes. While you would be exempt from the Arizona investment adviser licensing requirements because of your registration as a securities salesman, you are not precluded from licensing as an investment adviser. In fact, a sole proprietor who wishes to represent himself or herself as a “licensed” investment adviser must be licensed. The exam requirements would be applicable in this situation. (If the sole proprietor wished to rely on the registered salesman exemption and does not represent themselves as “licensed” investment advisers, then the exam requirements are not applicable.) Any solicitors of the sole proprietor would need to meet the licensure and exam requirements or have an appropriate exclusion or exemption. (Exam requirements are discussed in **Questions 19-25** and in the Investment Adviser Instruction Packet.)

### III.    Reporting Requirements **A.R.S. § 44-3159**

As a result of NSMIA, Arizona has enacted new laws creating different investment adviser reporting requirements depending on whether the investment adviser is (1) a notice filer, (2) a licensee with a principal place of business in Arizona or (3) a licensee whose principal place of business is outside Arizona. **The reporting requirements do not affect the investment advisers initial application for licensure or initial notice filings.**

A.    Licensee with principal place of business in Arizona **A.R.S. § 44-3159(A)**

To retain licensure in Arizona, a licensee must file with the Commission:

1.    a supplemental statement showing any material changes in fact contained in the initial application within 30 days after the change.
2.    An audited balance sheet if the licensee has custody of client funds or requires payment of at least \$500.00, six or more months in advance from any single client. Financial statements must be filed within 90 days after the end of the licensee’s fiscal year.

B. Licensee with principal place of business in another state **A.R.S. § 44-3159(C)**

These advisers will be exempt from the reporting requirements of **A.R.S. § 44-3159(A)** if all of the following requirements are met:

1. the investment adviser is registered as an investment adviser with the state in which it maintains its principal place of business.
2. the investment adviser has complied with the financial reporting requirements, if any, of the state in which it maintains its principal place of business.
3. the investment adviser files with the Commission a copy of any financial report which is filed with the state where it maintains its principal place of business.

While there is no definition of “principal place of business”, the SEC has defined investment advisers *principal office and place of business* as the “executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser.” **SEC Rule 203A-3(c)**.

C. Notice Filers do not have any Reporting Requirements in Arizona.

However, A.R.S. § 44-3153(D) and (E) allow the Commission to require notice filers to submit to the Commission any documents filed with the SEC. Currently, documents will be requested on a case by case basis only.

D. Questions and Answers

- Question 7**
- Q. I am an Arizona licensed investment adviser with my principal place of business in another state, with what reporting requirements must I comply?
- A. If you are registered in the state where your principal place of business is located, then you only need to provide to Arizona the financial report provided to your home state. If your home state does not require a financial report, then no reporting is necessary in Arizona.

- Question 8** Q. I am a SEC IA/Arizona notice filer with my principal place of business in another state, does Arizona have any reporting requirements with which I must comply?
- A. No.
- Question 9** Q. I am an SEC IA/Arizona notice filer with my principal place of business in Arizona, does Arizona have any reporting requirements with which I must comply?
- A. No.
- Question 10** Q. I am an Arizona licensee with my principal place of business in Arizona, but have no Arizona clients, am I subject to any reporting requirements?
- A. Yes. You must comply with **A.R.S. § 44-3159(A)** which requires your firm to file a supplemental statement showing any material changes in fact from that contained in your initial application within 30 days after the change, and an audited balance sheet within 90 days after your firm's fiscal year end, if required. It does not matter that your firm has no Arizona clients.

#### IV. Regulation of Investment Adviser Representatives

As a result of NSMIA, Arizona law relating to the regulation and licensing of IARs has changed. New federal law and rules have added a definition of IAR that is applicable to SEC IAs. The Arizona definition of IAR continues to be applicable in all other cases.

##### A. Definition of IAR

###### 1. IARs of SEC IAs

The definition of IAR found in **A.R.S. § 44-3101(3)** has, for all practical purposes, been preempted as it relates to IARs of SEC IAs. As such, the Division must apply the SEC definition of IAR to SEC IAs. **SEC Rule 203A-3(a)(1)** defines an IAR as a *supervised person* more than 10% of whose clients are natural persons. **Section 202(a)(25)** of the Investment Advisers Act of 1940 defines a *supervised person* as any partner, officer, director, or employee or other person who provides investment advice on behalf of the adviser and is subject to the supervision and control of the adviser. *Supervised persons* who do not, on a regular basis, solicit, meet with, or otherwise communicate with clients of the investment adviser, or who provide only impersonal advice, are excluded from the IAR definition.

2. IARs of Arizona Licensed Advisers and Non-Supervised Persons of SEC IAs (Please note the discussion of “solicitors” in **Question 14**)

**A.R.S. § 44-3101(3)** will continue to apply to all Arizona licensees. It defines an IAR as any partner, officer or director of an investment adviser, any person who occupies a status or performs functions similar to a partner, officer or director of an investment adviser or any other individual who is employed by or associated with an investment adviser, except clerical or ministerial personnel, and who does any of the following:

- a. makes any recommendations or otherwise renders advice regarding securities.
- b. manages accounts or portfolios of clients.
- c. determines which recommendation or advice regarding securities should be given to a client if the person is a member of the adviser’s investment committee that determines general investment advice to be given to client or the person determines general client advice if the investment adviser has no investment committee, except that if an adviser has more than 5 such persons, only the supervisors of such persons are IARs.
- d. solicits, offers or negotiates for the sale of or sells investment advisory services.
- e. directly supervises employees who perform any of the acts described above.

**B. IAR Licensure Requirements and Application A.R.S. §§ 44-3151 and 44-3156**

1. Arizona requires the licensing of IARs prior to their providing investment advisory services in Arizona.

IARs of SEC IAs are only subject to the licensing requirement if they have a *place of business* in Arizona. **SEC Rule 203A-3(b)** defines an IARs *place of business* as (1) an office at which an IAR regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients and (2) any other location that is held out to the general public as a location at which the IAR provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

IARs of Arizona licensees are required to be licensed regardless of whether or not the IAR has a *place of business* in Arizona.



2. To license an IAR in Arizona, the IAR must be associated with an Arizona investment adviser licensee or notice filer. An application to become an IAR shall include a completed Form U-4 and proof of the exam requirement. Such application requires the payment of a \$40.00 fee. (For details on the exam requirement, please see Investment Adviser Instruction Packet).

C. Questions and Answers

**Question 11** Q. Does Arizona require licensure of IARs of SEC IAs?

- A. Yes, IARs of SEC IAs who maintain a *place of business* in Arizona must be licensed.

**Question 12** Q. I fall within the federal definition of IAR for an SEC IA, however I do not have a place of business in Arizona and I only have clients in Arizona with whom I conduct business over the phone, must I be licensed as an IAR?

- A. No. As a result of NSMIA, Arizona may only require licensure from IARs of SEC IAs who maintain a *place of business* in Arizona. Determining what constitutes a *place of business* is a factual question which requires case by case analysis. (See definition of *place of business* above).

**Question 13** Q. I am an out of state based portfolio manager for an Arizona licensed investment adviser. I am a supervised person of the adviser but only 5% of my clients are natural persons. Am I required to be licensed as an IAR?

- A. Yes. Because the investment adviser is Arizona licensed, this question must be analyzed using Arizona's definition of IAR. A portfolio manager meets the Arizona definition of an IAR. It would not matter that only 5% of the clients were natural persons and that the IAR does not have a place of business in Arizona.

**Question 14** Q. I am a solicitor for an SEC IA, am I required to be licensed as an IAR?

- A. Clearly, solicitors who meet the federal definition of an IAR and have a *place of business* in Arizona will be required to license as IARs. Other solicitors will have to be analyzed on a case by case basis.

NSMIA only preempts Arizona and other states from the licensing of *supervised persons* of SEC IAs as IARs, it does not preempt Arizona from the licensing of non-supervised persons as investment advisers or IARs. The Final Rules (SEC Rel. No. IA-1633) appear to support the view that Arizona may

subject solicitors, who are not *supervised persons* to the licensing requirements, provided that such person falls within the Arizona definition of IAR.

The Arizona definition of IAR (**A.R.S. § 44-3101(3)**) includes individuals who are associated with investment advisers who solicit, offer or negotiate for the sale of or sells investment advisory services. This includes individuals who introduce or refer clients to investment advisers for compensation. Using this definition, Arizona may continue to license solicitors of SEC IAs who are not supervised persons (irrespective of place of business). (Please refer to **Question 26** for a discussion of “compensation”)

Arizona law regarding solicitors of Arizona licensed investment advisers has not changed. Arizona will continue to license all solicitors as either IARs or investment advisers.

## V. Exemptions and Exclusions from Licensure and Notice Filing Requirements

### A. De Minimis Exemption

**Section 222(d)** of the Investment Advisers Act of 1940 (as amended by NSMIA) preempts Arizona from requiring licensing or a notice filing from investment advisers who (1) do not have a *place of business* in Arizona **AND** (2) have fewer than 6 *clients* in Arizona during the preceding 12 months. Arizona’s de minimis exemption allowed no more than five present or prospective clients. SB 1097 amended **A.R.S. § 44-3152(a)(2)** to change the language to fewer than six clients.

1. *Place of business* -- **Section 222(a)** uses the same definition as the *place of business* for an IA as that of the place of business of an IAR found above.
2. *Client* -- The SEC has promulgated **SEC Rule 203(b)(3)-1** to assist investment advisers in calculating the number of *clients* an investment adviser has in a state. The rule sets forth certain groups of persons who are treated as a “single client” for purposes of this exemption. A “single client” will include (1) a natural person and (i) minor child of the natural person, (ii) any relative/spouse with the same principal residence, (iii) all accounts and trusts where the people in (i) and (ii) are the sole beneficiaries and (2) business entities that receive investment advice based on the entities objectives and not those of the actual owners and any other entities with identical owners. (Refer to **SEC Rule 203(b)(3)-1** for the text of the rule and to SEC Rel. No. IA-1633 for commentary regarding its application.)

B. Registered Dealer and Salesman Exclusion

**A.R.S. § 44-3152(C)** excludes from the requirements of the Arizona Investment Management Act all securities dealers and salesmen registered with the Commission. This exclusion applies not only to the licensing or notice filing requirements, but also excludes registered dealers and salesmen from the reporting, recordkeeping, exam and anti-fraud requirements of the Arizona Investment Management Act. However, registered dealers and salesman will continue to be subject to the analogous requirements of the Arizona Securities Act.

C. Exclusions from the Definition of Investment Adviser

As discussed above, certain persons are excluded from the definition of an investment adviser. These persons include IARs, depository institutions, attorneys, CPAs and publishers. For a complete list of those excluded from the definition (as well as an elaboration of the exclusions noted above, please refer to **A.R.S. § 44-3101**).

D. Investment advisers with no place of business in Arizona whose only clients in Arizona are investment companies, investment advisers, dealers, depository institutions . . . are exempt from Arizona licensure and notice filing requirements. (**A.R.S. § 44-3152(A)**).

E. Questions and Answers

**Question 15** Q. I am an SEC IA with a place of business in Arizona but fewer than six clients in Arizona, am I exempt from the notice filing requirements?

A. No. The de minimis exemption would not apply to this investment adviser because the adviser has a place of business in Arizona.

**Question 16** Q. I am an out of state investment adviser, not registered with the SEC, with 5 clients in Arizona, am I subject to Arizona licensing requirements?

A. No, so long as the investment adviser does not have a place of business in Arizona. If the investment adviser has a place of business and/or six or more clients in Arizona, then licensure would be required.

**Question 17** Q. As an attorney or CPA, may I hold myself out as providing investment advisory services without triggering the licensure or notice filing requirements?

A. No. Holding oneself out as providing investment advisory services indicates that the provision of these services is not solely incidental to the practice of their professions. Conducting one's business or profession in such a manner that would lead one to believe they were providing investment advisory services

would constitute “holding oneself out”. This can be as simple as an advertisement, a designation on a business card or a business card proclaiming financial planning services.

**Question 18** Q. I am a teacher in Arizona and provide investment advisory services for compensation to some of my students, must I register as an investment adviser in Arizona?

A. Yes. While you would be exempt from federal registration because of an exclusion from the federal definition of an investment adviser (**Section 202(a)(11)**), you would not be excluded from the Arizona definition. Therefore, you would be subject to the Arizona licensure or notice filing requirements. This reasoning will also apply to engineers and any other class of persons excluded by the federal definition, but not by Arizona’s.

#### VI. Arizona’s Antifraud Provisions

**Section 203(A)(b)(2)** of the Investment Advisers Act of 1940 specifically preserves Arizona’s authority to investigate and bring enforcement action against any investment adviser or person associated with an investment adviser. For the purposes of **A.R.S. § 44-3241**, Arizona’s antifraud statute, there is no distinction between licensees, notice filers or any other person committing fraud in the provision of investment advisory services.

#### VII. Examination Requirements -- Questions and Answers

**Question 19** Q: What are the required examinations to become licensed as an investment adviser in Arizona?

A: The Series 65, Investment Adviser Law Examination, or Series 66, the Uniform Combined State Law Examination *and* the Series 7, Series 2, or one of the professional designations. The Series 2 exam is no longer offered by the NASD and will only be applicable for those individuals who have previously passed this exam. (Please refer to Investment Adviser Instruction Packet).

**Question 20** Q: What is the difference between the Series 7 and the Series 2?

A: The Series 7 is the NASD General Securities Exam sponsored exam. The Series 2 is the non-NASD General Securities Exam, however, it is no longer being offered by the NASD.

**Question 21** Q: If I have taken the Series 63 exam, am I still required to take the Series 65 exam, or is it possible to get a waiver?

A: The Series 63 will not be accepted in place of the Series 65 or 66. The Series 65 or 66 is a mandatory requirement for licensing as an Investment Adviser or IAR. However, it should be noted that the Series 66 exam is a combination of the Series 63 and 65 exams. Thus, an individual who has not taken any exams as of yet, may wish to take the Series 66. The Series 66 will be accepted for both the Series 63 and Series 65.

**Question 22** Q: I have taken the Series 7, 24, 63 and have been in the business for the past twenty years, am I still required to take the Series 65 or 66?

A: Yes, the Series 65 or 66 is a mandatory requirement for licensing as an Investment Adviser or IAR.

**Question 23** Q: How long is the Series 65 exam?

A: It is a two hour exam consisting of seventy-five questions.

**Question 24** Q: Where can I get information about signing up and taking the Series 65 or any other NASD examination? Are there any preparatory courses that I can take for the Series 65 or 66?

A: The NASD can provide you with information on signing up and taking the Series 65 or 66. There are a number of preparatory courses to prepare you for the exam, although, please note that the Securities Division does not endorse these courses, but, provides them to you as a public service only.

**Question 25** Q: Where does one go to take the examinations in Phoenix?

A: The Sylvan Technology Center. Their telephone number is (602) 548-8220. They are located at 13615 N. 35th Avenue, Suite 8 in Phoenix.

#### VIII. Other Commonly Asked Investment Adviser Questions And Answers

**Question 26** Q: An investment adviser is defined in **A.R.S. § 44-3101(2)**, as any person who, for *compensation* engages in the business of advising other. . . I am not compensated by my clients, rather I receive commissions. Am I an investment adviser subject to the license or notice filing requirements?

A: Yes, you would meet the definition of an investment adviser. At issue is whether commissions constitute compensation. Compensation is construed broadly and is intended to include *any* compensation such as; referral fees, non-cash compensations, commission only sales, and barter (service for service)

transactions. Business referral arrangements will not be considered compensation so long as there is no sharing of compensation. Determining what constitutes *compensation* is a factual question which requires case by case analysis.

**Question 27** Q: I am an insurance agent licensed with the Department of Insurance, am I still required to license as an Investment Adviser?

A: An insurance company or agent whose performance of the investment advisory services are *solely incidental* to the conduct of business as an insurance company or agent *and* that receives *no special compensation* for providing investment advisory services would not be required to license.

**If you have any questions, please contact Dion McClellan at (602) 542-4242.**